



Office of Health Plan Administration

P.O. Box 720724

Sacramento, CA 94229-0724

Telecommunications Device for the Deaf, TTY 1 (800) 795-2929; (916) 795-3240

(916) 795-0041; FAX (916) 795-1513

Toll Free: **888 CalPERS** (or 888-225-7377)

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AGENDA ITEM 5a

TO: MEMBERS OF THE HEALTH BENEFITS COMMITTEE

- I. SUBJECT:** Health Maintenance Organization Financial Reserves Update
- II. PROGRAM:** Health Benefits
- III. RECOMMENDATION:** Information Only
- IV. INTRODUCTION:**

At the December 2007 Health Benefits Committee (HBC) meeting Blue Shield of California (Blue Shield) and Kaiser Health Plan (Kaiser) provided the HBC information regarding their financial reserves. The HBC requested quarterly updates of financial information regarding the contracting Health Maintenance Organizations (HMOs). This report is to provide the CalPERS Board of Administration (Board) with a financial update and information regarding the HMO reserves relating to the CalPERS membership. This update will be reported by the contracting HMOs.

V. ANALYSIS:

Blue Shield of California

In addition to providing an update on Blue Shield's financial reserves, Blue Shield agreed to provide the HBC with follow-up information on how financial reserves are invested. Blue Shield consistently uses industry standard methods to set and manage reserves. Based on historical comparisons of actual claims run-out to booked reserves, Blue Shield's reserving for CalPERS has been highly accurate. Independent reviews by external auditors have confirmed that Blue Shield's reserving is reasonable and accurate. Even if reserving is off in either direction, it has, at most, a minor and temporary effect on pricing due to the roll-over feature in the Blue Shield contract.

The financial position of the Access + HMO and the Exclusive Provider Organization (EPO) plans remain strong. The medical and pharmacy claims twelve month cost trend continues to show close to expected trends for 2007.

These financial results, plus adequate reserve levels, provide assurance that the rates approved by the Board for the 2007 plan year were sufficient to cover the cost of healthcare and administrative costs.

The assets of California Physicians' Service (dba: Blue Shield of California) are invested pursuant to the asset allocation guidelines contained in the company's Investment Policy, which is authorized by the Finance and Investment Committee (Committee) of the Board of Directors. Currently, the amount of cash and investments is well in excess of amounts needed to cover reserved claims liabilities. In accordance with the Investment Policy, the Committee periodically reviews the asset allocation guidelines and makes revisions as appropriate. Currently, the target allocations are 70 percent cash and fixed income investments and 30 percent equities. A separate allocated amount was invested to cover the obligations of certain benefit plans. Please note that Blue Shield has no exposure to sub-prime mortgage-backed securities or asset-backed securities and limited exposure to securities backed by Alt-A mortgages.

Key provisions of the Blue Shield Investment Policy include:

- Portfolios will conform with all applicable state and federal regulations, including, but not limited to, Section 1300.77 of the Knox-Keene Health Care Service Plan Act of 1975 (which pertains to regulatory reporting of investments in certain securities).
- Investment managers are retained to meet investment objectives and implement the asset allocation plan. Manager guidelines are established for each investment manager.
- Each manager will be measured relative to the performance benchmarks established by Blue Shield staff for the Manager's authorized asset class.
- No investment may be made in tobacco related companies.
- Investments in real estate are limited to 5 percent of the total portfolio's cost basis. Please note that investments in publicly traded equity real estate conduits such as real estate investment trusts (REITS) are included in the authorized allocation to common stocks.
- Derivative securities may be used only to hedge interest rate and currency risk.

Overall Blue Shield remains financially strong as shown by ratings from the credit rating agencies and its Risk Based Capital (RBC) level. Adequate reserves assure that the rates approved by the Board for the 2007 plan year were sufficient to cover the cost of healthcare and administrative costs.

Kaiser Health Plan

Kaiser, as an integrated care delivery system, does not have “reserves” or hold insurance risk like the CalPERS’ self-funded plan. However, it is important that our members understand where Kaiser stands financially and how that may affect CalPERS.

Kaiser ended 2007 with an operating margin of 4.6 percent. The operating margin is less than 5 cents on the dollar and in line with the organization’s goal to maintain a 4 percent to 6 percent margin. Kaiser’s performance demonstrates financial health and stability. Kaiser is on track to meet their long-term financial plan and managing their cost structure, which will help them meet their goal of reducing the rate of premium increases.

When reviewing Kaiser’s 2007 financial performance, it is important to keep several things in mind:

- As a not-for-profit organization, Kaiser does not have shareholders. Instead, the earned margin is used exclusively to reinvest in systems, people, facilities, medical equipment, and technologies that serve all members -- including 458,000 CalPERS members. The earned margin is not paid to shareholders in the form of dividends.
- Kaiser owns and operates the delivery system where care is provided, which means it is more like a hospital system and budgets around patient care. The delivery system is essentially a fixed cost – standing ready to provide the care CalPERS members, other Kaiser members, and the community needs.
- Where other insurers have claims after the care is provided, Kaiser has payroll for nurses, staff, and physicians, as well as costs for pharmaceuticals and medical supplies that are paid in advance.
- Kaiser also must plan to fund important enhancements, such as seismic retrofits, new hospitals, and medical technology.

In 2007, three factors contributed to Kaiser Permanente's positive performance:

Cost-improvement strategies.

Planned cost-improvement initiatives produced results sooner than anticipated. These savings come from efficiencies in managing the cost per stay in hospitals, as well as administrative efficiencies, including successful cost-containment strategies in information technology administration.

An adjustment for professional liability and worker's compensation.

Several initiatives and investments in patient safety and workplace safety contributed to this gain, as did California's workers compensation reform and tort reforms in various states.

Strong performance in the financial markets.

Kaiser invests in a variety of funds, including Fixed Income, U.S. Equities, International Equities, and Private Equity, and had strong returns in 2007.

Maintaining a positive financial position helps Kaiser provide sustained fiscal stability for CalPERS and other customers, and ensures they can provide high-quality, affordable health care well into the future.

VI. STRATEGIC PLAN:

This directly relates to Goal X: Develop and administer quality, sustainable health benefit programs that are responsive to and valued by enrollees and employers.

VII. RESULTS/COSTS:

There is no cost associated with this item.

Marcine Elvin Crane, Jr. MS, CPA
Chief, Office of Health Plan Administration

Gregory A. Franklin
Assistant Executive Officer
Health Benefits Branch